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No. 91-1135

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
Petitioner,

v.

THE UNITED STATES OF AMERICA,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

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BRIEF OF INDEPENDENT INSURANCE AGENTS OF AMERICA, NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS, NATIONAL ASSOCIATION OF INSURANCE BROKERS, NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS, THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, AND THE COALITION OF INDEPENDENT CASUALTY COMPANIES OF AMERICA, AS AMICI CURIAE, IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether customer-based intangibles with a limited useful life and an ascertainable value are nondepreciable goodwill.

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INTRODUCTION

This brief is filed on behalf of the Independent Insurance Agents of America, the National Association

of Casualty & Surety Agents, the National Association of Insurance Brokers, the National Association of Professional Insurance Agents, the National Association of Independent Insurers, and the Coalition of Independent Casualty Companies of America (the "Amici"), to urge this Court to reverse the judgment of the Third Circuit. The written consents of the parties to the filing of this brief have been filed with the Clerk of the Court.

THE AMICI

Independent Insurance Agents of America is the nation's largest independent insurance agent association, representing over 220,000 independent agents and their employees. Its members offer all lines of insurance, including property, casualty, life, and health insurance.

The National Association of Casualty & Surety Agents represents 300 of the nation's largest property and casualty insurance agencies and brokerages specializing in the sale and service of commercial insurance products to business, industry and municipalities.

The National Association of Insurance Brokers ("NAIB") is the national trade association of commercial insurance brokers. Founded in 1934, its members range in size from large international companies to regional and local firms. NAIB members represent clients in the United States and around the world. NAIB members administer the majority of coverage in the $110 billion commercial property and casualty insurance market in the United States.

The National Association of Professional Insurance Agents ("PIA") is a nonprofit trade association, representing 180,000 independent insurance agents and their employees who sell and service all lines of insurance, specializing in coverage for homes, autos and business. PIA is represented throughout the United States and Puerto Rico by members affiliated with forty-one PIA state or regional associations.

The National Association of Independent Insurers is a non-profit trade group representing the interests of over 500 property and casualty insurance companies in the United States.

The Coalition of Independent Casualty Companies of America is an association of small property and casualty insurance companies with members located in over thirty-five states and the District of Columbia.

THE INTERESTS OF THE AMICI IN THIS CASE

This case presents the issue of whether terminable-at-will customer relationships acquired by purchase are subject to the allowance for depreciation provided in section 167 of the Internal Revenue Code ("Code"), when they are acquired as part of an ongoing business. The outcome of this case could directly affect the value of the business assets of the Amici's members.

Numerous members of the Amici have, in the course of their trades or businesses, either purchased or sold intangible assets, including customer-based intangible assets. In fact, the bulk of the value of their businesses often consists of customer-based intangible assets, such as insurance expirations.

Many members of the Amici have been assessed additional tax or are the subject of adjustments proposed by the Internal Revenue Service (or may be in

the future), because they depreciate the cost of various intangible assets that they purchase. The Internal Revenue Service has often taken the position that insurance expirations and other insurance business intangible assets are in the nature of goodwill, and, therefore, are nonamortizable. The Service has prevailed in some cases, and taxpayers have prevailed in others. *See, e.g., Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667 (3d Cir. 1969); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976); *Robbins & Weill, Inc. v. United States*, 382 F. Supp. 1207 (M.D.N.C. 1974).

SUMMARY OF THE CASE

The issue in this case is whether a depreciation deduction under Code section 167 is available for the portion of the purchase price of eight Michigan newspapers purchased by Newark Morning Ledger Co. ("Morning Ledger") that was allocable to individually-identified, periodically-paying subscribers, each having terminable-at-will contracts for delivery of daily and/or Sunday editions of the respective newspapers.

To prevail on its claim, Morning Ledger had to prove that the subscriber relationships had: (1) an ascertainable value separate and distinct from goodwill; and (2) a limited useful life that could be estimated with reasonable accuracy. Pet. App. at 9a.[1]

The Third Circuit accepted the district court's finding that the Morning Ledger newspaper subscriptions had: (1) wasting lives that can be estimated with reasonable accuracy, and (2) ascertainable values. However, the Third Circuit held that the subscription contracts, because they were acquired as part of an ongoing business, were not "separate and distinct from goodwill," and accordingly were not depreciable.

[1] References are to pages of the Appendix to the Petition for a Writ of Certiorari.

In arriving at its conclusion, the Third Circuit viewed the issue before it as turning on the proper definition of "goodwill" and it accepted the formulation arguably found in one body of case law opinions: *i.e.*, that goodwill is "the expectation of continued patronage." On that basis, because "the projected stream of income to be generated by the 460,000 at-will subscribers is simply a quantification of Morning Ledger's expectation that these subscribers will continue their patronage," (Pet. App. at 11a), the Third Circuit held that Morning Ledger's newspaper subscription contracts were nondepreciable goodwill, notwithstanding that they have wasting lives that could be estimated with reasonable accuracy, and ascertainable values. The court further held that its view of goodwill as "the expectation of continued patronage" precluded the utilization of the residual method to determine goodwill and also precluded the utilization of the capitalized income stream method to value the subscription contracts.

SUMMARY OF ARGUMENT

The Third Circuit's definition of goodwill effectively creates a presumption, which is intended to be virtually impossible to refute, that all customer-based intangibles, acquired as part of an ongoing business, are themselves inherently part of goodwill and, therefore, nondepreciable. The Third Circuit reached its conclusion without analysis or concern as to why goodwill is treated as nondepreciable for income tax

purposes. The Third Circuit's position is inconsistent with fundamental historic federal income tax principles; illogical because it would provide radically different tax treatment for identical assets depending on whether such assets are acquired separately or as part of an ongoing business; contrary to existing case law; and wholly inconsistent with both Congressional action and inaction in this area.

Fundamental principles of tax policy require the matching of expenses to revenues for the taxable period to which the items are properly attributable. Denying a depreciation deduction for the cost of acquiring an asset with an ascertainable value and determinable useful life results in an inaccurate measurement of a taxpayer's taxable income, which would cause taxable income to exceed the taxpayer's net economic income. Therefore, the definition of goodwill should be drawn to exclude intangible assets with ascertainable values and with limited useful lives.

The Third Circuit incorrectly concluded that Congress has "stood mute" regarding the definition of goodwill. Recent legislative actions by Congress, in enacting section 1060 of the Code and in declining to enact legislation broadening the tax definition of goodwill to include customer-based intangibles, confirm that goodwill should be defined to exclude intangible assets with ascertainable values and with limited useful lives.

ARGUMENT

1. The Third Circuit's Expansive Definition of Goodwill Would Likely Serve to Preclude the Amici's Members from Offering Proof to Establish that Customer-Based Intangibles Purchased as Part of an Ongoing Insurance Business Have Characteristics Separate and Distinct From Non-Amortizable Goodwill.

The Third Circuit attempts, in effect, to create a presumption that all customer-based intangibles acquired as part of an ongoing business are inherently part of goodwill. Under the Third Circuit's standard, "for tax purposes, there are some intangible assets which, notwithstanding that they have wasting assets that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." Pet. App. at 29a. Thus, the Third Circuit concluded, "it is virtually impossible for the taxpayer to disentangle the potentially depreciable value of [customer-based intangibles] from the value of the nondepreciable goodwill," (Pet. App. at 17a) and, "it is simply often too difficult for the taxpayer and the court to separate the value of the [customer] list *qua* list from the goodwill value of the customer relationships/structure." Pet. App. at 29a.

Such a view is reminiscent of the "mass asset rule" discredited more than 18 years ago in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974),[2]

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[2] The Third Circuit, explaining the mass asset rule, stated:

> Until 1973, the Service successfully had persuaded the courts that documentary evidence of customer structure, such as a customer list, was generally sufficiently intertwined with goodwill, if not goodwill itself, so as

and should not be applied to intangibles such as insurance expirations, workforce-in-place, information base, licenses and permits, and other intangible assets essential to the insurance industry. Such a view is not consistent with economic reality, because each year, in numerous business acquisitions of insurance brokerages, agencies and insurance companies, members of the Amici do in fact establish the values and useful lives of such intangibles, separate and distinct from goodwill.

For instance, the Amici have particular expertise with respect to the values and useful lives of the customer-based intangibles that are part of an insurance brokerage business. Insurance brokers and agents recommend, place and service insurance and risk management programs on behalf of businesses, organizations, governmental agencies and individuals. Commercial insurance brokers and agents identify and define risks of their clients (e.g., property, general liability, environmental, marine and transportation risks) and locate insurance markets to provide insurance coverage.

The relevant information regarding each client that is maintained by insurance brokers and agents is known in the industry as insurance expirations. The information contained in insurance expirations will usually consist of a customer's name, address, and the nature of his insurance coverage with the agency, including the name of the carriers, the type and number of lines, the expiration and renewal dates, pre-

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to render depreciation inappropriate as a rule of thumb.

Pet. App. at 14a.

mium amount and schedules, payment ledgers, reports and a summary of policy terms. For commercial clients, insurance expirations may also describe the manner in which a customer's property and business operations have been rated or classified for insurance purposes, the rights of the insurance company to audit customer compliance with the terms of the policy, and the method of premium payment. Thus, an insurance expiration can be a detailed insurance profile of the customer and the insurance needs of a business.

An insurance broker or agent with the information that comprises the insurance expiration can generally outperform its competition with respect to that client and therefore has a significant competitive advantage.

Just as with tangible assets, insurance expirations are bought and sold in transactions separate from the acquisition of an entire business. They have also been used as collateral in commercial transactions, and lenders have perfected security interests under the Uniform Commercial Code on insurance expirations.

The insurance industry recognizes that insurance expirations have a limited useful life. The information becomes obsolete over a period of time. Factors influencing the obsolescence of insurance expirations include price competition on premiums and fees charged for coverage, changes in a client's risk management personnel and philosophy, competitors' efforts to convince a client that it can better serve the client's insurance brokerage and risk management needs, and changes in the risk management needs of the client

due to mergers, liquidations, expansion, contractions, as well as other factors.[3]

Similarly, members of the Amici are able to determine the values and useful lives of other intangible assets, such as workforce-in-place, covenants not to sue, licenses and permits, etc. that are often part of a particular insurance business. However, under the Third Circuit's erroneous view of the nature of such assets, the Amici members' ability to establish the separate values and useful lives of such intangible assets would no longer be determinative on the issue of depreciability.

2. The Third Circuit Decision is Fundamentally At Odds with the Basic Tax Policy Objective of Matching Income and Expense and With the Net Income Nature of Our Federal Income Tax System.

As an economic matter, the purchaser of an ongoing business with stable, existing customer relationships expects to earn a quantifiable income stream from those existing customer accounts, and can project with reasonable certainty the average expected remaining useful life of those specific, identifiable customer accounts. The purchase price for the business invariably takes into account these customer relationships and the associated projected income stream, just as the purchase price takes into account the value of tangible personal property.

The purpose of depreciation and amortization deductions is to facilitate the proper reporting of taxable income on a net income basis, by permitting taxpayers to offset the costs of capital expenditures for wasting

[3] The Appendix to this brief contains a detailed description of the characteristics of insurance expirations.

assets against the income generated by those assets. *See generally* Treasury Regulations sections 1.167(a)-1 and 1.167(a)-3. Through such provisions, the Code "endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *INDOPCO, Inc. v. United States*, 112 S. Ct. 1039, 1043 (1992). *See also Massey Motors v. United States*, 364 U.S. 92, 96 (1960). To the extent a taxpayer is prevented from recovering through depreciation the cost of a wasting asset with an ascertainable value, the taxpayer's taxable income is overstated, and the taxpayer is subjected to a tax in excess of what the tax would be on the taxpayer's net economic income.

As a matter of sound tax policy, then, a taxpayer should be entitled to amortize its acquisition cost for customer-based intangible assets, regardless of whether or not they are acquired as part of an ongoing business, if the taxpayer can factually demonstrate that these assets have a limited useful life, the duration of which can be estimated with reasonable accuracy, and thus an ascertainable value separate and distinct from goodwill. Therefore, the tax definition of goodwill should be drawn to exclude intangible assets with ascertainable values and limited lives.

A careful review of the apparent historic basis for the prohibition against the amortization of goodwill suggests that the definition of goodwill for tax purposes should be narrowly construed. The current prohibition against the amortization of goodwill originally appeared as a 1927 amendment to Article 163 of Treasury Regulation 69. That amendment appears to have been in direct response to then-pending litigation

with respect to whether a decline in the value of goodwill of a brewery attributable to the onset of Prohibition justified a deduction for such loss in value. In that litigation this Court, overruling a Second Circuit decision to the contrary,[4] ultimately held that goodwill was not amortizable in such a situation. *Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930). The Court's decision clearly was strongly influenced by the narrow and historically unique non-tax policy consideration that goodwill associated with the production of alcohol was involved.

Many courts have concluded that depreciation is not allowable for goodwill because the useful life of goodwill is indeterminable. Thus, as courts have stated, for tax purposes, goodwill is, by definition, an intangible asset that has an indefinite life. *See, e.g., Richard S. Miller & Sons, Inc., supra*; *Colorado National Bankshares v. Commissioner*, 60 T.C.M. 771, 789 (1990).

Considering the basic tax policy objective of accurately measuring net income, sound tax policy would argue strongly in favor of narrowly, rather than broadly, construing the definition of goodwill. At a minimum, those considerations suggest that a taxpayer should have the ability to amortize assets that it has proved have a determinable value and useful life and are thus separable from goodwill.

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[4] *Haberle Crystal Springs Brewing Co. v. Clarke*, 30 F.2d 219 (2d Cir. 1929).

3. The Distinction Adopted by the Third Circuit Between Customer-Based Intangible Assets Separately Purchased and those Acquired as Part of an Ongoing Business is Illogical, and Inconsistent with the Fundamental Tax Policy Objective of Horizontal Equity.

As a business matter, customer-based intangibles—such as newspaper subscription lists, insurance expirations and existing customer accounts—*can be and are* purchased separately from ongoing businesses. The Third Circuit recognized that, when such assets are purchased separately, they may properly be amortized for federal income tax purposes. It is illogical to conclude that somehow such assets lose their separate identity and become unamortizable goodwill, if they are purchased as part of an ongoing business. Rather, as *Houston Chronicle* observed, "[o]ur view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets." 481 F.2d at 1253.

The Third Circuit's position also unfairly discriminates against taxpayers who purchase intangible assets as part of an entire business. Another tenet of the federal income tax system is that, as far as possible, similarly situated taxpayers should pay the same tax. *Commissioner v. Idaho Power Company*, 418 U.S. 1, 14 (1974). The objective of that fundamental policy of "horizontal equity" is to have persons with equal economic incomes pay the same amount of taxes. The Third Circuit's position is not consistent with the goal of horizontal equity. The Third Circuit would allow taxpayers who purchase intangible assets in separate transactions to depreciate their cost, but would prevent other taxpayers from recovering the cost of iden-

tical intangible assets having the same determinable value and the same ascertainable useful life, if purchased as part of an entire business. Allowing depreciation deductions to the first set of taxpayers, while preventing the second set of taxpayers from recovering their costs through depreciation deductions, is wholly inconsistent with sound tax policy.

If the Third Circuit's position stands, it is likely that a two-tiered valuation system will develop for customer-based intangible assets that will place an unwarranted premium on the form an acquisition takes. Assets such as insurance expirations, purchased separately from a trade or business, whose cost is depreciable for tax purposes, will carry a higher value than the same assets purchased as part of an ongoing business, which carry the tax "penalty" of nondepreciability. Under this two-tiered system, those taxpayers who, because of economic circumstances or other reasons, need to sell their entire businesses, would experience a diminution in the value of their business assets. That diminution is estimated at between 12% and 20% as compared with the value the businesses would have if those assets were clearly amortizable.

4. The Third Circuit's Decision Fundamentally Misinterprets Existing Case Law.

The cases relied on by the Third Circuit for the traditional definition of goodwill as "expectancy of continued patronage" fall into three categories: (a) old cases that apply the now-repudiated "mass asset rule;"[5] (b) cases that hold that the depreciability of

[5] Indeed, the Third Circuit's line of reasoning to the effect that "goodwill = expectancy of continued patronage = customer lists = goodwill," is virtually indistinguishable from the quintessential articulation of the discredited and repudiated "mass-asset rule" contained in *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938, 942-44 (Ct. Cl. 1967).

specific intangible assets, acquired as part of an ongoing business, depends on the factual criteria described above, but conclude on the facts of the particular case that the taxpayer failed to carry its burden of proof; and (c) cases in which the taxpayer carried its burden of proof and was entitled to depreciate the intangible asset in question. Thus, prior to the Third Circuit's decision, numerous courts saw no inconsistency between the traditional definition of goodwill and the allowance of a depreciation deduction for discrete customer-based intangibles acquired as part of an ongoing business, *if* the taxpayer met its burden of proof as a factual matter. Undoubtedly they recognized, as did the district court in *Newark Morning Ledger*, that "one must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis." Pet. App. at 32a-33a. *See also Citizens & Southern Corp. v. Commissioner*, 91 T.C. 466, 499 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990); *Super Food Services Inc. v. United States*, *supra*, 416 F.2d at 1239; *Computing & Software Inc. v. Commissioner*, 64 T.C. 223, 233 (1975); and *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269, 273-274 (1977).

In summary, the Third Circuit's decision ignores the case law precedent that terminable-at-will customer relationships may in fact properly be amortized for tax purposes, particularly in view of "the realities

of modern business technology in a day when lists are bartered and sold as discrete vendible assets." *Houston Chronicle, supra*, 481 F.2d at 1253. Thus, for example, the Seventh Circuit stated in *Super Food Services, Inc.*, 416 F.2d 1236 (7th Cir. 1969):

> It is immaterial that the contracts may have no fixed termination date. [citations omitted] In our view, . . . it is also immaterial whether these [terminable-at-will] contracts were acquired separately or as part of a going business. Any quarrel with the going concern value of contracts acquired as part of a business is properly directed to the allocation to be made between goodwill and the contracts purchased and should not be relied on as requiring a complete denial of the depreciation deduction to contracts shown to have a limited useful life.

416 F.2d at 1240.

Similarly, in *Citizens & Southern, supra*, the Tax Court stated:

> The fact that a deposit account has no fixed termination date and is terminable at will does not as a matter of law prevent petitioner from factually showing that deposit base has an ascertainable cost basis separate and distinct from goodwill and that it has a reasonably ascertainable useful life. [citations omitted] We emphasize the factual nature of our inquiry.

91 T.C. at 48.

In the current case, the parties stipulated the useful lives of the assets in question and Morning Ledger

introduced substantial, uncontroverted evidence that such assets were separate and distinct from goodwill. The district court rendered its decision based on its factual findings in favor of the taxpayer. Only by misconstruing applicable law was the Third Circuit able to override the district court's decision.

5. The Third Circuit's Apparent Rejection of the Residual Valuation Method for Determining Goodwill and the Income Forecast Method Is Erroneous.

The Third Circuit erroneously asserts that current law prevents a taxpayer from utilizing the residual method for separating customer-based intangibles from goodwill and limits a taxpayer to the cost method of valuing customer-based intangibles. Both assertions are erroneous.

Congress not only has approved the use of the residual method to value goodwill separately from intangibles, but in fact has mandated such treatment. Under Code sections 1060 and 338,as well as Treasury Regulations section 1.338(b)-2T(b), such treatment is required when allocating consideration to the basis of acquired assets. Moreover, case law prior to sections 332 and 1060 (including a Third Circuit decision) also applied the residual method to determine goodwill in appropriate circumstances.[6]

Furthermore, Congress in 1987 specifically declined to legislate that customer-based intangibles have to

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[6] *See, e.g., Jack Daniel Distillery v. U.S.*, 379 F.2d 569, 579 (Ct. Cl. 1967); *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 320-323 (1977), *aff'd*, 591 F.2d 248 (3d Cir.). *cert. denied*, 444 U.S. 829 (1979). The residual method has generally been viewed as more favorable to the government than alternative methods because it generally results in a greater amount of goodwill. *See generally Philip Morris, Inc. v. Commissioner*, 96 T.C. 660 (1991).

be treated as nondepreciable intangible assets with indeterminate useful lives. Section 10120 of H.R. 3545, the Revenue Bill of 1987, would have treated customer-based and similar intangibles as having an indeterminate useful life. Section 10120 was dropped by the conference committee prior to the enactment of H.R. 3545, as Title X of the Omnibus Budget Reconciliation Act of 1987.[7]

Regarding valuation methods, Congress, in the course of enacting Code section 1060, explicitly recognized that the income stream or capitalization of earnings method of determining fair market value is one of the "commonly accepted methods" of asset valuation for purposes of determining the tax basis of assets in the context of the acquisition of an ongoing business.[8]

Moreover, in addition to the erroneous nature of the Third Circuit's assertion that the income stream method is impermissible, the court's acceptance of the cost method is wholly inconsistent with the factual determination of the lower court concerning the Internal Revenue Service's cost basis valuation:

> In response to the expert opinions submitted by plaintiff, defendants offered experts

[7] Congress is currently considering H.R. 1456, the "Intangibles Amortization Clarification Act of 1991," that would clarify that customer-based intangibles are amortizable under current law. H.R. 1456 is co-sponsored by over 190 members of the Ho of Representatives. Its companion bill in the Senate, S. 1245, has 9 co-sponsors.

[8] S. Rpt. No. 99-313, 99th Cong. 2nd Sess. p. 252. *See also General Explanation of the Tax Reform Act of 1986* (Committee Print, 1987) at 356 (explaining the status of the law prior to enactment of section 1060).

> who were unqualified, valued the wrong asset and utilized inappropriate methodology.

Pet. App. at 43a.

It is particularly important to emphasize the district court's determination that the Internal Revenue Service's experts valued the "wrong asset," because it underscores the deficiencies of applying the cost method to these types of assets. The application of the cost method assumes that the cost of separately generating these customer-based intangibles occurs in a vacuum, *i.e.*, it begins from the assumption that the customer pool one is attempting to assemble is not already committed to another service provider. This is rarely the case. As a result, use of a cost method in the manner advocated by the Internal Revenue Service would rarely reflect economic reality.

CONCLUSION

The Amici respectfully urge that the Court reverse the Third Circuit.

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APPENDIX

APPENDIX

A. Productive Nature of Insurance Expiration Assets

Commercial insurance brokers recommend, place and service insurance and risk management programs on behalf of businesses, organizations, governmental agencies and individuals. Commercial insurance brokers are typically engaged to identify and define risks (e.g., property, general liability, environmental, marine and transportation risks) and locate insurance markets to provide insurance coverage.

The information that comprises the customer-based intangible asset known as Insurance Expirations is the quintessential asset of an insurance broker's business. The exclusive information that comprises the Insurance Expiration asset allows insurance brokers to reliably and efficiently generate revenue. The Insurance Expiration asset has been defined to consist of the following:

> [I]nformation relating to a customer's name, address, and the nature of his insurance coverage with the agency, i.e., name of the carrier(s), type and number of lines, expiration (renewal) dates, premium amounts and schedules, payment ledgers, reports, and a summary of policy terms.[1]

Among other uses, Insurance Expirations are used by brokers and agents to timely renew and adjust a client's insurance coverage.[2] The information that comprises the Insurance Expiration asset allows insurance brokers to timely evaluate (i) whether a client should continue to insure or self-insure its risks, (ii) whether a client can reduce its cost or increase the services its receives (such as claims handling) by obtaining coverage from a different insurance carrier or (iii) whether a change in a client's business (e.g.,

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[1] *Robins & Weill, Inc. v. U.S.*, 382 F. Supp. 1207 (M.D.N.C. 1974).

[2] *Richard S. Miller & Sons, Inc. v. U.S.*, 537 F.2d 446 (Ct.Cl. 1976).

exposure to new risks) requires enhancements to existing insurance coverage or new coverage altogether. In addition to enabling timely renewal and adjustment of coverage, Insurance Expiration information allows insurance brokers to provide other quality risk management services including (i) comparing a client's coverage with coverage provided to others with similar risks, (ii) recommending other risk management and related services to clients and (iii) developing and marketing "group" insurance programs for clients that share similar risks and require similar insurance protection. Simply stated, the insurance broker or agent that possesses the information that comprises the Insurance Expiration asset has a significant competitive advantage and can generally outperform its competition with respect to that client.

Due to the confidential nature of the Insurance Expiration asset, insurance brokers and agents will generally institute procedures within their firms to help assure that employees, former employees, co-brokers, insurers and competitors are not able to obtain and misuse the Insurance Expiration asset for their own commercial gain. When such assets are misused by employees, former employees or co-brokers or are unfairly obtained by competitors, the courts have recognized the commercial value of Insurance Expirations and have enforced the terms of agreements protecting the confidential nature of such assets, or enforced common law contract and fiduciary standards to protect the rightful owner of the asset.[3] Disputes regarding

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[3] *Alexander & Alexander Inc. v. Van Impe*, 787 F.2d 163 (3rd Cir. 1986); *Alexander & Alexander Benefits Services Inc. v. Benefits Brokers & Consultants. Inc.*, 756 F. Supp. 1408 D. Ore. 1991);*Alexander & Alexander Inc. v. Drayton*, 378 F. Supp. 824 (E.D. Pa. 1974); *Alexander & Alexander Inc. v. Danahy*, 488 N.E. 2nd 22 (Mass. Ct. App. 1986), *Alexander & Alexander Services Inc. v. Frederick Reed, et al.*, No. 84 CH 9844 (Cook County, Ill. Cir. Ct. 1986). The Uniform Trade Secrets Act has been enacted in over a dozen states. It generally codifies existing common law principles protecting an employer's confidential

the ownership or use of Insurance Expirations are often settled without the necessity of litigation. Such settlements have required the return of the Insurance Expiration asset to the broker claiming exclusive ownership, enjoining the wrongful taker from the future use of the asset or compensating the rightful owner equal to the value of the asset.

In addition to the courts, the insurance brokerage industry and insurance carriers recognize an insurance broker's exclusive ownership rights to its Insurance Expirations. In agency agreements between an insurance broker and an insurance carrier, the insurance broker is recognized as the owner of the Insurance Expirations although the insurance carrier can seize the Insurance Expiration pursuant to the agency agreement if the insurance broker is delinquent in remitting premiums. In other words, the agency agreement treats the Insurance Expiration asset as collateral for the insurance broker's obligation to remit premiums to the carrier.

Similar to tangible assets, Insurance Expirations are bought and sold among insurance brokers in separate transactions.[4] (Goodwill, on the other hand, is incapable of being separately bought and sold.[5]) A market for Insurance Expirations exists because, as indicated above, ownership of Insurance Expirations affords insurance brokers a com-

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information about its clients and customers. The case *Alexander & Alexander Benefits Services. Inc. v. Benefits Brokers & Consultants, Inc., supra*, holds that an insurance broker's confidential information about its clients' renewal dates, losses and risk characteristics were trade secrets under the Oregon Uniform Trade Secrets Act, and thus entitled to the protection afforded by that act.

[4] The U.S. Court of Claims in *Richard S. Miller & Sons, supra*, acknowledged the insurance expirations can be sold in discrete transactions.

[5] *Dodge Brothers Inc. v. U.S.*, 118 F.2d 95 (4th Cir. 1941) citing *Metropolitan National Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (S.C. 1893).

petitive advantage and because some brokers that specialize in providing particular types of insurance often desire to acquire Insurance Expirations within their specialty. Conversely, brokers that do not desire to specialize will often sell acquired or developed Insurance Expirations that require specialized knowledge.

Since Insurance Expirations have recognized commercial value, they have been used as collateral in commercial transactions. Additionally, security interests have been perfected under the Uniform Commercial Code when Insurance Expirations have been sold and full payment has not been received at the time of sale.

The accounting profession recognizes that Insurance Expirations are a separate asset that constitutes the major portion of the cost associated with the acquisition of an insurance broker.[6] The accounting profession has acknowledged that Insurance Expirations are an "identifiable" asset that is distinguishable from goodwill. Generally accepted accounting principles ("GAAP") and the tax law are similar in that intangible assets must be identified, valued and amortized over their estimated useful lives. GAAP requires an allocation of fair market value to intangible assets to insure that expenses are not understated and are properly matched with revenue.[7]

Other governmental agencies have also recognized the existence of the Insurance Expiration asset and issued guidelines regarding the method to value such assets. For example, the Federal Home Loan Bank Board has issued specific valuation guidelines regarding the method to properly value Insurance Expirations so as to provide standards to produce satisfactory evidence to support the purchase price of insurance agencies and brokers.[8]

[6] Insurance Agents and Brokers Task Force of the Insurance Companies Committee, Accounting Standards Division, American Institute of Certified Public Accountants, *Exposure Draft Proposed Industry Accounting Guide. Insurance Agents and Brokers*, par. 8.4, August 15, 1991.

[7] Accounting Principles Board Opinion 16, "Business Combinations" and Accounting Principles Board Opinion 17, "Intangible Assets."

B. Insurance Expirations Have a Limited Useful Life

Common sense indicates that the information that comprises the Insurance Expiration asset has a limited useful life since that information will become obsolete over a period of time. Factors that influence the obsolescence of Insurance Expirations include: (i) price competition on premiums and fees charged for coverage; (ii) changes in the client's risk management personnel and philosophy; (iii) competitors' efforts to convince a client that it can better serve that client's insurance brokerage and risk management needs and (iv) changes in the risk management needs of a client due to, among other reasons, mergers, liquidations, expansion, contraction or discontinuance of lines of business, changes in governmental regulations and standards, litigation hazards and changes in insurance carriers' willingness and ability to provide insurance coverage.

Insurance industry statistics indicate that an average Insurance Expiration has a useful life of seven years.[9] However, actual useful lives will vary depending on type of coverage, amount of commission, insurance broker practices and procedures to protect the asset, competitors' efforts and local economic factors.

[8] FHLBB #R-28 Memorandum Series, #R 28b (April 1976). The purpose of the FHLBB guidelines is to provide support for a loan since lenders attempt to avoid making loans that exceed the value of the assets acquired by borrowers.

[9] *Vaaler Insurance Inc. v. U.S.*, 68-1 USTC ¶ 9183, at 86,284 (D.N.D. 1968).